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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-979

APPALACHIAN POWER COMPANY,
Appellant,

v.

THE PUBLIC SERVICE COMMISSION OF WEST VIRGINIA,
Appellee.

ON APPEAL FROM THE SUPREME COURT OF APPEALS
OF THE STATE OF WEST VIRGINIA

BRIEF OPPOSING MOTION TO DISMISS OR AFFIRM

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Appalachian Power Company ("Appalachian" or "the Company") hereby opposes the Motion to Dismiss or Affirm ("Motion") filed by the West Virginia Public Service Commission ("the Commission") in response to Appalachian's Jurisdictional Statement.

The Motion never once addresses the central issue—the end result of the Commission's rate orders is to leave Appalachian in a position where it is unable to raise the money necessary for the proper discharge of its public duties. It cannot even legally issue additional long-term debt or preferred stock and, since common stock is the most expensive type of capital, Appalachian obviously cannot meet its capital needs from this source.

INTRODUCTION

It is important to emphasize at the outset that there appears to be agreement between the parties on the essential facts. The Commission does not dispute Appalachian's requirement to spend more than $1 billion during the next three years in order to provide safe and reliable electric service to more than 678,000 customers in West Virginia and Virginia. Nor does the Commission dispute the fact that the end result of its decision is that Appalachian is precluded from legally issuing additional long-term debt securities or preferred stock, the types of capital least expensive to the ratepayers, to finance this $1 billion construction program. Also, in its Motion the Commission explicitly agrees with the Company's evaluation of its credit standing—the lowest of any major electric utility in the United States. The dispute between the Company and the Commission centers on the significance of these facts in evaluating the rate orders of the Commission in this proceeding under the standard of constitutional reasonableness articulated by this Court over more than 50 years.

Notwithstanding the many diversionary ploys contained in the Commission's voluminous Motion, this Court is not being asked to sift through a complicated factual situation to review findings of fact made by an administrative agency. The essence of this appeal is that the Commission failed to apply the proper constitutional standard; in misinterpreting or ignoring decisions of this Court in *Bluefield Water Works & Improvement Company* v. *Public Service Commission of West Virginia,* 262 U.S. 679 (1923) (*"Bluefield"*), and *Federal Power Commission* v. *Hope Natural Gas Company,* 320 U.S. 591 (1944) (*"Hope"*), the Commission violated Appalachian's constitutional right to rates which are adequate to permit the Company to attract the capital necessary to provide safe and reliable public utility service.

There are at least two substantial federal questions presented in this appeal. First, the Commission's decision effectively repudiates the capital attraction standard established in *Bluefield* and *Hope,* a result which, if applied in other regulatory jurisdictions, would have disastrous consequences for investor-owned public utilities and ultimately could bring about their extinction. Second, if allowed to stand, the Commission's decision will have an immediate detrimental burden on interstate commerce, affecting directly the reliable supply of electricity to the citizens of West Virginia, Virginia and Tennessee, and indirectly electric service to a large segment of the population in numerous other states.

In its attempt to defend its decisions in this case, the Commission has presented many justifications not considered in its orders below, many of which involve erroneous or misleading statements, or proffered "facts" for which there is no record support. For example, in its Motion the Commission suggests that the Company is excessively leveraged (pp. 25-26); that the Company's problems are the result of poor or imprudent management (p. 30); that the Company chose to increase debt at a time when interest rates are highest (p. 30); that the Company inflated its depreciation expense (p. 37); that the Company could increase earnings for coverage purposes by utilizing a consolidated income statement (p. 37); that the Company's method of financing its construction may not be the most efficient (p. 44); and that the Company should sell portions of its affiliated coal properties in order to raise needed capital (p. 45). All of these arguments have two common defects—they are raised for the first time and they are wrong. The Court should not be misled by the Commission's *post hoc* rationalizations for its actions. As this Court noted in *Securities and Exchange Commission* v. *Chenery Corporation,* 332 U.S. 194 at 196 (1947):

> [A] reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency. If those grounds are inadequate or improper, the court is powerless to affirm the administrative action by substituting what it considers to be a more adequate or proper basis.

The importance of these substantial federal questions to the citizens of Virginia is eloquently emphasized in the Brief of the Commonwealth of Virginia as Amicus Curiae ("Virginia Brief") in requesting this Court to assume jurisdiction and grant the appeal in this case. The actions of the West Virginia Commission have so eroded the private rights of Appalachian as to pose a real and immediate danger to the public rights of hundreds of thousands of citizens of the Commonwealth of Virginia. As such, this proceeding has assumed the substance if not the form of a controversy between states whose importance ". . . transcends the immediate financial integrity and credit standing of Appalachian."[1]

I

THE COMMISSION FAILED TO APPLY THE CONSTITUTIONAL STANDARDS ENUNCIATED IN *BLUEFIELD* AND *HOPE*.

While never disagreeing that the end result of its orders is to eliminate Appalachian's ability to issue additional senior securities, the Commission at several points argues that the minimum constitutional requirements of public utility rates are effectively below minimum legal coverage requirements and thus coverage requirements are not embraced by the Fifth and Fourteenth Amendments to the

1 Virginia Brief, p. 3.

Constitution;[2] that Appalachian's coverage problems are a result of the Company's capital structure and not the Commission's rate decision;[3] and, repeatedly, that the allowance of a 9.35% rate of return, designed to produce an overall return of $46 million annually, amounts to an irrefutable determination of the constitutionality of the Commission's decision.[4] The common thread of all of these arguments is that Appalachian's ability to attract or even legally issue additional senior capital is irrelevant to the determination of a fair and reasonable rate of return. None of these propositions is well-founded.

Contrary to numerous statements contained in the Commission's Motion, the Company does not contend that 2.0 times interest coverage or any particular coverage level is a constitutional requirement. Rather, the gravamen of Appalachian's argument is that bond indenture and preferred stock coverage levels *do* represent an objective, easily calculable and absolutely minimum measure of the Company's ability to attract the additional capital needed to fund its construction program, and in that sense represent an essential element in the capital attraction standard of constitutional reasonableness set forth in the *Bluefield* and *Hope* decisions.

The necessity of meeting certain minimum coverage requirements prior to issuing additional senior securities is for Appalachian a matter of law pursuant to regulations of the Securities and Exchange Commission under Sections 6 and 7 of the Public Utility Holding Company Act of 1935 ("Holding Company Act") and also is a matter of private contract between the Company and the holders of more than $800 million of its outstanding debt securities. The minimum debt coverage requirement of course is not the

2 Motion, pp. 8, 11, 19.

3 *Id.*, pp. 22-32, 35-38.

4 *Id.*, pp. 9, 10, 18, 31.

2.0 times annual interest charges so frequently referred to in the Commission's Motion, because the interest which must be covered twice over is the sum of the outstanding interest *plus* the interest on the new debt to be issued.[5] The requirement of private contract law is similar to that of the vast majority of indentures of investor-owned electric utilities in the United States; the requirement of the Securities and Exchange Commission applies uniformly to all companies in public utility holding company systems registered under the Holding Company Act.

The Commission's argument that coverage is not relevant to the constitutionality of public utility rates would, if accepted by this Court, effectively reverse more than 50 years of precedent including *Bluefield* and *Hope*. Those cases and numerous others unequivocally establish that the ability to attract capital is a requirement which must be satisfied if public utility rates are to pass constitutional muster. If "ability to attract capital" has any vitality, it necessarily must embrace meeting the minimum legal criteria to issue long-term debt and preferred stock, the two least expensive types of permanent capital.

The conglomeration of peripheral arguments presented by the Commission in its Motion makes no attempt to meet the essential capital attraction issue. For example, the Commission's suggestion that a 9.35% overall rate of return calculated to produce $46 million of "net operating profits" *a priori* makes its decision constitutional, fails to consider other equally vital aspects of the ratemaking calculus and ignores the end result test established in *Hope*. A rate of return by itself is a meaningless number.[6] In

5 Obviously a bare minimum indenture coverage of 2.0 times annual interest requirements or a slim additional margin is not an appropriate level of coverage and will not maintain the financial integrity of the Company. It is only a requirement below which *no* additional long-term debt may be issued.

6 The comparison to rate of return allowed in Virginia is equally meaningless.

order for any rate of return to assume significance in the light of the utility's earnings it must be measured against the utility's investment (rate base) after giving full consideration to all operation and maintenance expense, depreciation, and taxes. A utility's ability to attract capital can be deprived just as easily by measuring a seemingly fair rate of return against a rate base which is far less than the utility's current investment, or by understating expense below that actually incurred, or by imputing revenues at higher than actual levels, or by establishing an improper class of non-jurisdictional customers, or by making the rates so established effective two or three years after the year in which the investment is measured. The interaction of the various elements of the rate-making process has worked in this case to deprive Appalachian of even approaching the earnings levels suggested by the Commission. While the Commission at numerous instances insists that its decision provides $46 million of West Virginia jurisdictional "net operating profits", the fact—of which the Commission is well aware—is that Appalachian's *total-company* net earnings for common in 1977 were less than $40 million, a return on equity of less than 8%.

Clearly within any individual part of the total ratemaking calculus a regulatory agency has broad discretionary authority. However, when the sum of its actions — the end result — fails to result in rates sufficient to permit the utility to attract any additional long-term debt capital or preferred stock capital, the Commission has overstepped its otherwise broad discretionary authority and transgressed into the area of unconstitutional confiscation of property.

There can be no better test of the end result than minimum legal coverage tests. Those tests are objective arithmetical exercises, calculated from actual per-books results and cost of securities to be issued, and require no judgment or expertise.

II

THE COMMISSION'S *POST HOC* RATIONALIZATIONS ABOUT COVERAGE ARE MISLEADING AND INACCURATE, AND SHOULD BE REJECTED BY THIS COURT.

At numerous points throughout its Motion, the Commission introduces extraneous and erroneous examples of coverage calculations not included in the evidentiary record or the Commission's decisions. Without ever denying the fact that the end result of its orders is to eliminate Appalachian's legal ability to issue additional senior capital, the Commission attempts to show that this end result is the product of the Company's and not the Commission's action, and that rate regulation which would afford Appalachian the legal ability to issue additional senior capital would result in excessive returns on common equity. These examples are misleading and obviously intended deliberately to confuse the clear-cut issues which are presented in this appeal.

The Commission's Motion continuously confuses operating income before taxes, operating income after taxes, coverages on the two different bases, and net earnings for common after interest expense and preferred dividends. For example, the Commission ignores the fact that the legal coverage test which Appalachian must meet is based on net earnings before interest and *income taxes*. Thus the final column at page 33 of the Motion grossly overstates the net earnings for stockholders which would, of course, be on an after-tax basis. Similarly, the entire textual example at page 34 of the Motion makes no provision for the income taxes associated with $56 million of net earnings available for common equity and accordingly completely misstates the coverage result. Moreover, even if the example had correctly reflected the appropriate allowance for income

taxes, the suggestion that the Company's annual interest expense would double without any corresponding change in the level of equity investment is so simplistic and naive as to make the example meaningless.

The Commission suggests[7] that coverage could be improved by reducing depreciation expense or taxes (other than income taxes) without indicating a means or rationale for understanding the former or evading the latter and, indeed, the Commission challenged the levels of neither item on the record in this case.

The Commission repeatedly argues that the Company is highly debt leveraged, and thus management has created its own coverage problems which should not be resolved by Commission action. The Commission's arguments must be rejected. The percentage of debt subject to the Company's debenture coverage test is presently lsss than 54% of Appalachian's total capitalization, a level comparable to the electric utility industry average debt ratio. The Commission's misleading statement that Appalachian's debt ratio is 61%[8] ignores the fact that the Company's debt (reflected in the 61%) includes more than $100 million of capitalized instalment purchase contracts associated with tax-exempt revenue bond pollution control financings (approximately 7% of the capital structure) which is not treated as long-term debt for coverage purposes. Similarly, the Commission states that "Appalachian's senior capital as a percentage of total capital has ranged from 67.51% to 70.23%,"[9] implying erroneously that this is significantly related to the Company's interest coverage calculations. Table 3 at page 27 of the Motion indicates that the Commission has included capitalized installment purchase contracts, short-term debt and preferred stock in the "senior

7 Motion, p. 23.

8 *Id.*, p. 36.

9 *Id.*, p. 26.

capital" calculation, none of which affects the coverage test for issuing new long-term debt. Indeed, Table 3 illustrates that the Company's common equity ratio has increased, albeit modestly, over the five-year period. Thus, when the Commission states that "Appalachian has obviously chosen to increase debt at a time when interest rates are highest,"[10] Table 3 confirms that the Commission is misrepresenting the facts to this Court. There has not been an increased use of long-term debt, but simply a continued *pro rata* division among the various sources of capital of the total financing requirements needed to cover the costs of new capital expenditures and, actually, a *reduction* in the percentage of total capital represented by long-term debt subject to the interest coverage test. Presumably, the Commission would have the Company alter its capital structure by issuing additional common equity to finance its construction program. The Commission is oblivious to the fact that a company which cannot even legally attract less costly debt or preferred equity is simply unable to attract common equity in the substantial amounts required.

At numerous points the Commission attempts to disclaim any regulatory authority over Appalachian's capital structure, simply because it lacks statutory authority to approve the Company's security offerings. Such disclaimers should be given no weight by this Court. The Commission in recent rate proceedings has had ample opportunity to seek to modify the Company's capital structure by imputing a different capital structure for ratemaking purposes.[11] Instead, the Commission has accepted for ratemaking pur-

10 *Id.*, p. 30.

11 In numerous instances where regulatory commissions have believed that a utility's equity capitalization was too high, the commission has reduced the ratio for ratemaking purposes. See *In the Matter of Communications Satellite Corporation*, 56 F.C.C.2d 1101, 1157-1158 (1976); *Re New England Teleph. & Teleg. Co.*, 13 P.U.R. 4th 65, 68-69 (Me. P.U.C. 1976).

poses the Company's actual capitalization and saved its arguments about leverage for judicial appeals. Appalachian's capital structure is within the capital structure standards approved by the Securities and Exchange Commission under the Holding Company Act and each issuance of Appalachian's long-term debt and preferred or common stock is authorized by the Securities and Exchange Commission after public notice. Thus, in light of the Company's actual capital structure, the Commission's "reasonable modification"[12] is absurd. The Company's actual debt ratio subject to the coverage test was already below 54% at the end of 1977, and, after reflecting the total impact of all of the Commission's actions in the instant case, Appalachian's debt interest coverage at December 31, 1977, calculated in accordance with the applicable indenture on a *total-company basis,* was 1.67 times.

The Commission devotes pages 22-32 of its Motion to arguing that coverage as a critical test in ratemaking would result in a bonanza to the common shareholders. These hypothetical and incorrect arguments, even if they were accurate, are not relevant to this case since there has never been a finding by the Commission that Appalachian's capital structure is excessively leveraged. Appalachian's return on common equity in 1977 of less than 8% is hardly a bonanza.

The Commission reasons that it would be profitable to the equity owners not only to increase the utility's debt leverage but also to borrow at higher interest rates even if lower rates were available. This reasoning hardly deserves comment. It completely ignores the fact, first of all, that the use of debt, other things being equal, is less expensive for both the customers and the Company because of tax deductibility of interest and relatively lower cost of debt compared to equity. It ignores the financial axiom

12 Motion, p. 36.

that increasing amounts of interest expose the equity holder to greater risk. It ignores the fact that the Securities and Exchange Commission requires a minimum of 30% common equity for companies subject to the requirements of the Holding Company Act and that very few electric companies have more than 40%—a rather narrow range, not the 30-90% suggested in the Commission's Table 2.[13] Moreover, it assumes the adoption of a specified coverage level, such as 2.0 times, as the *sole* test in setting rates; it further assumes that the utility's rates would be automatically adjusted to satisfy the new coverage requirements each time the utility changed its outstanding debt in any respect. Appalachian is of course not contending for any such ratemaking standard. Appalachian is contending that the ability to attract capital necessarily embraces meeting the minimum legal criteria to issue senior securities where the Company's capital structure is reasonable and its need to attract capital is unquestioned.

The Commission seems to believe that its decision was adequate to meet the coverage arguments raised by Appalachian, since the Company in fact issued long-term debt in 1975 and 1976. Here again, the Commission is misleading this Court. First, two of the five issues referred to by the Commission were refunding issues for which the Company is not required to meet a coverage test. Second and more important, the Commission fails to point out that the coverage which permitted the other three security issues was the result in part of revenues being collected subject to refund. If the Commission's final decisions had been effective at the time of these various security offerings, Appalachian would not have had the minimum legal coverage requirements necessary to be able legally to issue all of such securities.

The Commission's accusation that the Company has failed to disclose two items which materially affect cover-

13 *Id.*, p. 26.

age is wrong.[14] First, the depreciation expense ($1.4 million) was originally recorded by the Company since it was reflected in the rate application to the Commission. As a result of the Commission's decision in this case, this entry has been reversed on the Company's books. The resulting total-company coverage for the 12-month period ended December 31, 1977 was 1.67 times.[15] Second, the alleged $5 million increase in earnings which purportedly would result from a consolidated income statement would have no effect on coverage because, as the Commission should be well aware, Appalachian's coverage test must be applied on a corporate (*i.e.*, non-consolidated) basis.

Finally, the Commission's frequent suggestions that Appalachian's new rate case (filed in September 1977) will correct the constitutional deficiencies of the Commission's decision in this proceeding should be summarily rejected. As Mr. Justice Cardozo so succinctly stated, "[p]resent confiscation is not atoned for by merely holding out the hope of a better life to come." *West Ohio Gas Company* v. *Public Utilities Commission of Ohio* (No. 2), 294 U. S. 79, 83 (1935).

14 *Id.* pp. 37, 48-49.

15 For the 12-month period ended August 31, 1977, after reversing the depreciation referred to by the Commission and including the fuel expense allowed by the Commission in its decision of January 13, 1978 (Commission Appendix G), coverage was 1.87 times on a total-company basis. The jurisdictional coverage ratios, based on allocation procedure advocated in the record by the Commission's Staff, results in corresponding coverage ratios of 2.82 for the Virginia retail jurisdiction and 1.80 for the West Virginia retail jurisdiction.

III

THE FACTS IN THIS CASE BELIE THE COMMISSION'S ASSERTION THAT NO BURDEN ON INTERSTATE COMMERCE RESULTS FROM THE COMMISSION'S ORDERS; THERE ARE COMPETING DEMANDS OF STATE AND NATIONAL INTERESTS WHICH THIS COURT SHOULD RECONCILE.

The Commission's Motion characterizes this case as being concerned with "the sale of electricity of an *intrastate* nature" and therefore being a matter solely for determination by the Commission.[16] The fact that the Commission's jurisdiction is limited to West Virginia cannot insulate this decision from the requirements of the Commerce Clause. It is inconceivable that when one state's regulation directly threatens the availability of reliable electric utility service in sister states, the Commerce Clause does not protect the national interest in reliable electric service in the several states—yet this is precisely what the Commission argues.

The Commission has acknowledged facts which belie any conclusion that interstate commerce is not adversely affected by the Commission's orders. Appalachian is engaged in the interstate transmission of electric energy[17] including service to over 330,000 retail customers in Virginia, and also 21 firm wholesale customers in Virginia, West Virginia and Tennessee whose service is regulated by the Federal Energy Regulatory Commission; Appalachian, as explicitly recognized by the Commonwealth of Virginia, is facing an immediate serious inadequacy of generating capacity to serve its customers; it is engaged in a construction program exceeding $1 billion requiring massive external financing; and the Commission's orders preclude issu-

16 Motion, p. 40.

17 *Id.*

ance of additional senior securities to permit timely construction of these facilities. As stated by the Commonwealth of Virginia, given these acknowledged facts, the "cost of service to citizens of the Commonwealth may increase and the adequacy of service may be jeopardized."[18] Service to millions of customers of Appalachian's sister American Electric Power System companies throughout the Midwest would be similarly threatened.

The Commission would dismiss these facts by mistaken notions that Appalachian's demands are premature because the scheduled completion date of Appalachian's 1,300,000 Kw New Haven plant is not until the winter of 1980/81, financing is needed in each of the years 1978-81, and the possibility that other financing modes could be utilized.[19] An inability to issue senior securities in 1978 inevitably will mean that the plant will not be placed in service in time to meet Appalachian's winter demands of 1980/81. Moreover, the Commission conveniently ignores that financing in 1978 will require coverage calculations based at least in part upon earnings in 1977 and the first quarter of 1978, the level of which directly depends on the outcome of this case.

The Commission contends that, on legal grounds, its rate determinations are matters for its own discretion, matters of local concern, and not matters for scrutiny concerning their effect on interstate commerce. The law is to the contrary. As this Court has clearly stated, "ever since *Gibbons* v. *Ogden*, 9 Wheat. 1, the states have not been deemed to have authority to impede substantially the free flow of commerce from state to state . . ."[20] Clearly a considered weighing of state and federal interests is mandated.

18 Virginia Brief, p. 2.

19 Motion, pp. 44-46.

20 *Southern Pacific Company* v. *Arizona*, 325 U.S. 761, 767 (1945).

The Commission concludes with the novel argument that the effects on interstate commerce of failing to carry out new construction which is required to meet anticipated future demands is "futuristic".[21] This argument ignores the realities of the electric utility business where a minimum of six years is required to design and construct a major generating plant to meet future demands for service. The plant must be built according to a plan or schedule and the monies must be financed as they are spent; otherwise construction of the plant will have to be delayed. It is no answer to say that the effect of the delay on the Company's ability to render adequate service will not be felt until the future. As noted by this Court in *Commonwealth of Pennsylvania* v. *State of West Virginia,* 262 U.S. 553 at 593 (1923):

> One does not have to await the consummation of threatened injury to obtain preventive relief. If the injury is certainly impending that is enough.

On the present facts, it is not necessary—indeed it is foolhardy—to await failure of electric service to assess the extent of the burden on interstate commerce where implications of failure to construct needed capacity have been demonstrated without challenge on the record.

Finally, Appalachian in its aggravated condition is compelled to suggest to this Court that the current energy shortage in Ohio and elsewhere resulting from the coal miners' strike is mild in terms of the national interest compared with the power shortages that will be experienced in the 1980's if the Commission's decision is allowed to stand and a similar parochial attitude should be widely adopted by other commissions.

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21 Motion, p. 49.

CONCLUSION

This appeal presents two substantial federal questions of compelling importance in the context of the national energy crisis. The State of West Virginia seeks to justify as constitutional electric utility rates which eliminate the Company's ability to issue senior securities—a position which cannot possibly comport with *Bluefield* and *Hope*. The State of West Virginia seeks to justify as constitutional electric utility rates which so imperil the reliable supply of electricity to the Commonwealth of Virginia as to necessitate the Commonwealth's Brief to urge this Court to grant the appeal. Surely this Court should act to protect both the private interests of Appalachian and the public interests of the citizens of Virginia, West Virginia, and numerous other states.

Appalachian respectfully requests the Court to deny Appellee's Motion, and to note probable jurisdiction, or, in the alternative, vacate the final orders appealed from and remand the case for such further proceedings as the Court may deem proper.

Respectfully submitted,

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